Appendix I - Draft Treasury Management Strategy Statement 2023/24

Introduction

1.0 Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

2.0 Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

External Context

3.0 The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on the Authority's treasury management strategy for 2023/24.

4.0 The Bank of England (BoE) increased Bank Rate by 0.75% to 3.0% in November 2022, the largest single rate hike since 1989 and the eighth successive rise since December 2021. The decision was voted for by a 7-2 majority of the Monetary Policy Committee (MPC), with one of the two dissenters voting for a 0.50% rise and the other for just a 0.25% rise.

5.0 The November quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK with CPI inflation remaining elevated at over 10% in the near-term. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is expected remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.

6.0 The UK economy grew by 0.2% between April and June 2022, but the BoE forecasts Gross Domestic Product (GDP) will decline 0.75% in the second half of the calendar year due to the squeeze on household income from higher energy costs and goods prices. Growth is then expected to continue to fall throughout 2023 and the first half of 2024.

7.0 CPI inflation is expected to peak at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if Bank Rate follows the path implied by financial markets with a peak of 5.25%. However the BoE has stated it considers this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target.

8.0 The labour market remains tight for now, with the most recent statistics showing the unemployment rate fell to 3.5%, driven mostly by a shrinking labour force. Earnings were up strongly in nominal terms by 6% for total pay and 5.4% for regular pay but factoring in inflation means real total pay was -2.4% and regular pay -2.9%. Looking forward, the MPR shows the labour market weakening in response to the deteriorating outlook for growth, leading to the unemployment rate rising to around 6.5% in 2025.

9.0 Interest rates have also been rising sharply in the US, with the Federal Reserve increasing the range on its key interest rate by 0.75% in November 2022 to 3.75%-4.0%. This was the fourth successive 0.75% rise in a pace of tightening that has seen rates increase from 0.25%-0.50% in March 2022. Annual inflation has been slowing in the US but remains above 8%. GDP grew at an annualised rate of 2.6% between July and September 2022, a better-than-expected rise, but with official interest rates expected to rise even further in the coming months, a recession in the region is widely expected at some point during 2023.

10.0 Inflation has been rising consistently in the Euro Zone since the start of the year, hitting an annual rate of 10.7% in October 2022. Economic growth has been weakening with an expansion of just 0.2% in the three months to September 2022. As with the UK and US, the European Central Bank has been on an interest rate tightening cycle, pushing up its three key interest rates by 0.75% in October, the third major increase in a row, taking its main refinancing rate to 2% and deposit facility rate to 1.5%.

Credit outlook

11.0 Credit default swap (CDS) prices have followed an upward trend throughout the year, indicating higher credit risk. They have been boosted by the war in Ukraine, increasing economic and political uncertainty and a weaker global and UK outlook, but remain well below the levels seen at the beginning of the Covid-19 pandemic.

12.0 CDS price volatility has been higher in 2022 compared to 2021 and this year has seen a divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities once again.

13.0 The weakening economic picture during 2022 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several local authorities and financial institutions, revising them from to negative from stable.

14.0 There are competing tensions in the banking sector which could impact bank balance sheet strength going forward. The weakening economic outlook and likely recessions in many regions increase the possibility of a deterioration in the quality of banks' assets, while higher interest rates provide a boost to net income and profitability.

Interest rate forecast

15.0 The Council's treasury management adviser Arlingclose is forecasting that the Bank Rate will continue to rise in 2022 and 2023 as the Bank of England attempts to subdue inflation which is significantly above its 2% target.

16.0 While interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. Arlingclose expects Bank Rate to rise to 4.25% by June 2023 under its central case, with the risks in the near- and medium-term to the upside should inflation not evolve as the Bank forecasts and remains persistently higher.

17.0 Yields are expected to remain broadly at current levels over the medium-term, with 5-, 10- and 20-year gilt yields expected to average around 3.6%, 3.7%, and 3.9% respectively over the 3-year period to September 2025. The risks for short, medium and longer-term yields are judged to be broadly balanced over the forecast horizon. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

18.0 A more detailed economic and interest rate forecast provided by Arlingclose is in Appendix 1.

19.0 For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate of 3%, and that new long-term loans will be borrowed at an average rate of 4%.

Local Context

20.0 The Council's borrowing as at 31st December 2022 will be summarised in 21.0 below and detailed in Appendix 2 once available later this year.

21.0 At 31st December 2022, the Council held £X.Xm of borrowing (£X.Xm long term and £X.Xm short term) and £X.Xm of investments. This is set out in further detail at ***Appendix 2***. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

22.0 Table 1: Balance sheet summary and forecast

	31.3.22	31.3.23	31.3.24	31.3.25	31.3.26
	Actual	Forecast	Forecast	Forecast	Forecast
	£m	£m	£m	£m	£m
Capital financing requirement	998.5	1,146.6	1,395.1	1,571.6	1,632.0
Other debt liabilities *	25.6	25.6	25.6	25.6	25.6
Loans CFR	**1,024.1**	**1,172.3**	**1,420.7**	**1,597.3**	**1,657.6**
External borrowing **	(684.6)	(681.7)	(618.3)	(609.9)	(601.6)

Internal (over) borrowing	**339.6**	**490.6**	**802.4**	**987.4**	**1,056.0**
Less: Balance Sheet resources	(438.2)	(438.2)	(438.2)	(438.2)	(438.2)
Treasury Investments (or New borrowing)	**98.6**	**(52.4)**	**(364.2)**	**(549.2)**	**(617.8)**

* leases and PFI liabilities that form part of the Authority's total debt

** shows only loans to which the Authority is committed and excludes optional refinancing

23.0 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's strategy has been to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. This means the Council has minimised its interest costs by utilising internal resources over the short term instead of undertaking more expensive external borrowing. As our internal resources are being depleted, there is an increasing need for the Council to undertake new external borrowing to fund the capital programme. The Council will need to borrow up to £617.8m over the forecast period.

24.0 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2023/24.

Liability Benchmark

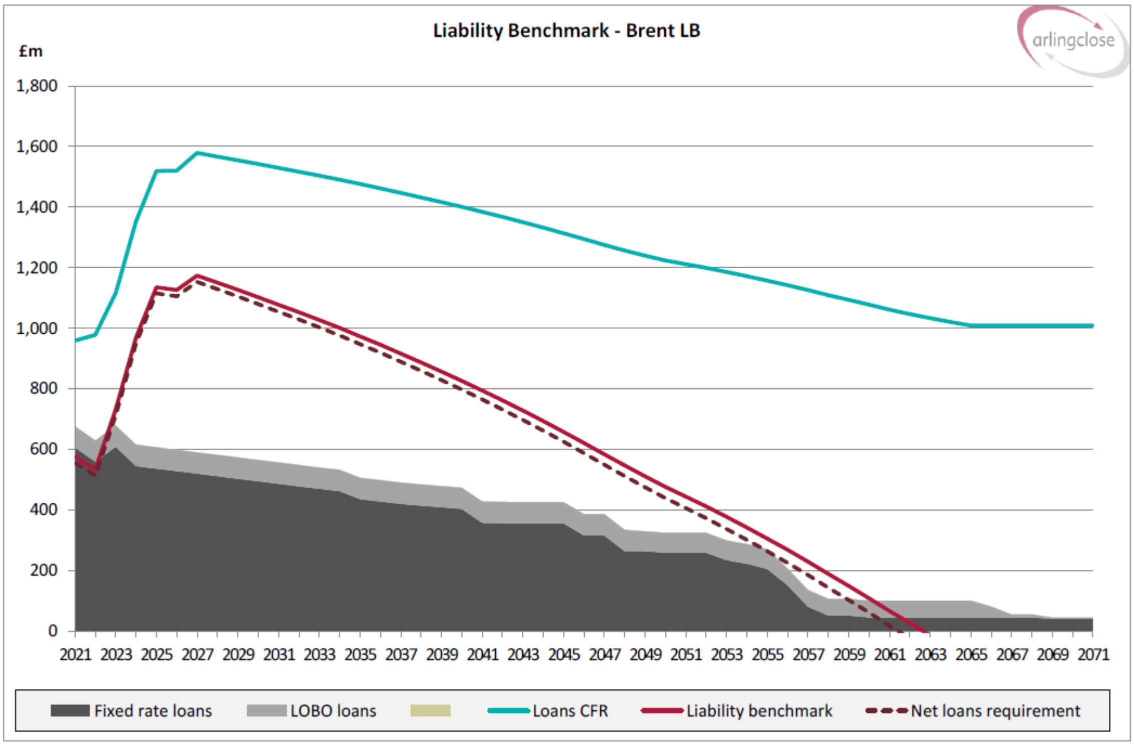
25.0 To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes that cash and investment balances are kept to a minimum level to maintain sufficient liquidity but minimise credit risk.

26.0 The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

27.0 Table 2: Prudential Indicator: Liability benchmark

	31.3.22	31.3.23	31.3.24	31.3.25	31.3.26
	Actual	**Forecast**	**Forecast**	**Forecast**	**Forecast**
	£m	**£m**	**£m**	**£m**	**£m**
Loans CFR	1,024.1	1,172.3	1,420.7	1,597.3	1,657.6
Less: Balance sheet resources	(438.2)	(438.2)	(438.2)	(438.2)	(438.2)
Net loans requirement	**586.0**	**734.1**	**982.5**	**1,159.1**	**1,219.4**
Plus: Liquidity allowance	20.0	20.0	20.0	20.0	20.0
Liability benchmark	**606.0**	**754.1**	**1,002.5**	**1,179.1**	**1,239.4**

28.0 Following on from the medium-term forecasts in table 2 above, the long-term liability benchmark assumes minimum revenue provision on new capital expenditure based on a 5 - 60 year asset life and income, expenditure and reserves all increasing by inflation of 2.5% a year. This is shown in the chart below:



29.0 The Loan CFR (Blue lines) represents the need to fund capital expenditure through borrowing. The Liability benchmark (Red Lines) represents the level of borrowing requirement once reserves and working capital has been taken into account. Where the liability benchmark exceeds the Council's current borrowing levels (Grey area), this indicates the real need to borrow.

Borrowing Strategy

30.0 The Council currently holds £684.6m million of loans, an increase of £25.5m (Last year £659.1m) million on the previous year, due to the decrease in internal cash reserves and planned capital expenditure. The balance sheet forecast in Table 1 shows that the Council expects to borrow up to £1,219m by 2025/26 however, this is largely dependent on how the capital programme progresses. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £1.5 billion.

31.0 **Objectives:** The Council's main objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

32.0 **Strategy:** Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. Interest rates have increased across the yield curve over the past year. The Council will continue to work closely with our Treasury advisors Arlingclose in order to borrow at optimal points avoiding the worst of the market volatility. Where appropriate, the Council may increase the proportion of it's debt held for short-term maturities.

33.0 In order to ensure long term stability of the debt portfolio, a proportion of the portfolio will be funded by long term borrowing. Where is affordable, this can help provide certainty to ensure the ongoing viability for capital programme schemes in these volatile markets.

34.0 **Sources of borrowing:** The approved sources of long-term and short-term borrowing are:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the local Brent Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

35.0 **Other sources of debt finance:** In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- Leasing
- Hire purchase
- Private Finance Initiative
- Sale and leaseback

36.0 The Council has previously raised the majority of its long term borrowing from the PWLB and will continue to do so in 2023/24. The Council will also consider the arrangement of forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

37.0 PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield. The Council has not undertaken such borrowing and has no plans to in future, which ensures continuing access to PWLB borrowing facilities.

38.0 In addition to above, the Council may borrow short-term loans to cover temporary cash flow pressures from other Local Authorities.

39.0 **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It issues bonds on the capital markets and lends the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to members.

40.0 **LOBOs:** The Council holds £70.5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. £26m of these LOBOs have options during 2023/24. Due to higher market rates, there is now a significant risk that some existing LOBO's may now require refinancing at higher rates or will require repaying.

41.0 **Short-term and variable rate loans:** These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below. Financial derivatives may be used to manage this interest rate risk (see section 69 below).

42.0 **Debt rescheduling:** The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Treasury Investment Strategy

43.0 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's treasury investment balance has ranged between £37.7m and £124.5m due to capital expenditure utilising the Council's internal cash reserves. These balances are expected to remain low for the remainder of the year with cash available to invest for relatively short periods.

44.0 **Objectives:** The CIPFA Code requires the Council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested. The Authority aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

45.0 **Strategy:** Given the increasing risk and very low returns from short-term unsecured bank investments, the Council continue to monitor higher yielding asset classes during 2023/24. This represents a continuation of the strategy adopted in 2018/19. However, it is worth noting that this approach will be limited to the extent that the capital investment plans are delivered in line with current expectations. Should this prove to be the case, surplus funds will not be available to invest over longer durations as set out below.

46.0 **ESG Policy -** Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Authority's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, the Council will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

47.0 Currently, the majority of the Council's surplus cash remains invested in short-term money market funds. The average rate of interest received on short-term investments during the year to December 22 was X% with an average duration of X%. Due to the authorities borrowing requirement, there is unlikely to be scope to improve the short term investment returns achieved as liquidity of the surplus funds will play a key role.

48.0 The Council will maintain a minimum investment balance of £10m to ensure the Council complies with the requirements to be a professional client under MIFID II regulations.

49.0 **Business models:** Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

50.0 **Credit Rating:** Treasury investments in the sectors marked with an asterisk will only be made with entities whose long-term credit rating is no lower than A-. The Council uses the lowest rating quoted by the main rating agencies, as recommended by CIPFA. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account. Within these criteria the Director of Finance will have discretion to accept or reject individual institutions as counterparties on the basis of any information which may become available.

51.0 Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Any institution will be suspended or removed should any factors give rise to concern, and caution will be paramount in reaching any investment decision regardless of the counterparty or the circumstances. Should an entity's credit rating be downgraded so that it does not meet the Council's approved criteria then:

- No new investments will be made;
- Full consideration will be made to the recall or sale of existing investments with the affected counterparty.

52.0 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "negative watch") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

53.0 Having an appropriate lending list of counterparties, remains critically important to protecting Brent's investments. A list of extremely secure counterparties would be very small, and the limits with each would be correspondingly high. This would expose the Council to a risk of an unlikely but potentially large loss. This arises because the arrangements for dealing with banks in difficulty now require a loss to be imposed on various categories of liabilities of the banks to allow the bank to recapitalise itself and continue in business (sometimes referred to as bail in).

54.0 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

55.0 **Government:** Loans to, and bonds and bills issued or guaranteed by, national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

56.0 **Banks and building societies (unsecured):** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. There is no upper limit to the maximum credit loss that the Council could suffer in the event of a bail-in scenario. See section 54 below for arrangements relating to operational bank accounts. Investments in unsecured deposits will be limited to £20m.

57.0 **Registered providers (unsecured):** Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed. Investments with registered providers will be limited to £20m in 2023/24.

58.0 **Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments. The Council and its advisors remain alert for signs of credit or market distress that might adversely affect the Council. Investments in secured deposits will be limited to £20m.

59.0 **Money market funds (MMFs):** Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times. Deposits will not exceed 0.5% of the net asset value of the MMF. In addition, each Fund will be limited to a maximum deposit of £20m.

60.0 The investment strategy will provide flexibility to invest cash for longer periods in order to access higher investment returns. The upper limit for lending beyond a year is £50m. In practice, lending for more than one year will be only to institutions of the highest credit quality and at rates which justify the liquidity risk involved. Marketable instruments may have longer maturities, though the maturity will be considered in conjunction with the likely liquidity of the market and credit quality of the institution. Other than UK Central Government the Council may invest its surplus funds subject to a maximum duration of 25 years.

Alternative investment options will include:

61.0 **Strategic pooled funds:** Bond, equity and property funds that offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly. Although considered as pooled funds, MMF's are discussed separately in paragraph 34. The Council currently has no investments in Pooled Funds (other than MMFs) at present, but may make prudent use of them in the future. Investments in pooled funds will be limited to £20m in 2023/24.

62.0 **Real estate investment trusts (REITs):** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties. The risk with any investments in REITs is that shares cannot be withdrawn but can be sold on the stock market to another investor which leaves the Council open to market risk. Investments in REITs will be limited to £20m in 2023/24.

63.0 **Other investments:** This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the Council's investment at risk.

64.0 **Operational bank accounts:** The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity. The Council banks with National Westminster Bank (NatWest) who meet the Council's minimum credit criteria. Should Natwest's creditworthiness deteriorate below the Council's minimum credit criteria, then as far as is consistent with operational efficiency, no money will be placed with NatWest and credit balances in the various Council accounts will be kept to a minimum level.

Investment limits: The Council's revenue reserves available to cover investment losses are forecast to be £384 million on 31st March 2023. In order that no more than 10% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government and Council subsidiaries) will be £20 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

65.0 *Table 3: Investment Limits*

	Credit Quality	Cash limit	Time Limit
Any single organisation, except a Government entity	A- Or equivalent	£20m	n/a
UK Government	Any	Unlimited	50 years
Local Authorities & other government entities	Any	Unlimited	25 years
Banks (unsecured)*	A- Or equivalent	£20m	13 months
Building Societies (unsecured)*	A- Or equivalent	£20m	13 months
Registered providers and registered social landlords*	A- Or equivalent	£20m	5 years
Secured investments*	A- Or equivalent	£20m	5 years
Money market funds*	A- Or equivalent	Lower of 5% of total net assets of the fund or £20m	n/a
Strategic pooled funds*	A- Or equivalent	£20m	n/a
Real estate investment trusts*	A- Or equivalent	£20m	n/a
Other Investments*	A- Or equivalent	£50m	5 years

*** Minimum credit rating:** Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

For entities without published credit ratings, investments may be made either (a) where external advice indicates the entity to be of similar credit quality; or (b) to a maximum of £200,000 per counterparty as part of a diversified pool e.g. via a peer-to-peer platform.

66.0 **Liquidity management:** The Council uses internal purpose-built cash flow modelling tools to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast. The Council aims to spread its liquid cash over at least two providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

TREASURY MANAGEMENT PRUDENTIAL INDICATORS

67.0 The Council measures and manages its exposures to treasury management risks using the following indicators.

68.0 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Table 4: Credit risk indicator

Credit risk indicator	Target
Portfolio average credit rating	A

69.0 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

Table 5: Liquidity risk indicator

Liquidity risk indicator	Target
Total cash available within 3 months	£20m

70.0 **Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Table 6: Interest rate risk indicator

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£5m
Upper limit on one-year revenue impact of a 1% fall in interest rates	£5m

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

71.0 **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Table 7: Refinancing rate risk indicator

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	40%	0%
12 months and within 24 months	40%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	60%	0%
10 years and within 20 years	75%	0%
20 years and within 30 years	75%	0%
30 years and within 40 years	75%	0%
Over 40 years	75%	0%

Time periods start on the first day of each financial year. LOBOs are classified as maturing on the next call date i.e. the earliest date that the lender can require repayment.

72.0 **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Table 8: Price risk indicator

Price risk indicator	2023/24	2024/25	2025/26
Limit on principal invested beyond year end	£50m	£50m	£50m

Related Matters

73.0 The CIPFA Code requires the Council to include the following in its treasury management strategy.

74.0 **Financial Derivatives:** A Derivative is a contract between two or more parties to hedge against the risk associated with the performance of an underlying asset. Local authorities have previously made use of financial derivatives embedded into its loans and investments both to reduce interest rate risk and to reduce costs or increase income at the expense of greater risk.

75.0 The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

76.0 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to.

77.0 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

78.0 In line with the CIPFA Code, the Council will seek external advice and consult with Members before entering into financial derivatives to ensure that it fully understands the implications. This will include analysis of the impact on interest rate, refinancing, counterparty, market, regulatory and legal risks, together with an assessment on the effectiveness of the derivative.

79.0 **Housing Revenue Account:** On 1st April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/ credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA at the Council's average interest rate on investments, adjusted for credit risk.

80.0 **Markets in Financial Instruments Directive:** The MiFID II regulations took effect from January 2018 which saw the council reclassified as a retail client with the opportunity to opt up to professional client status. Retail clients have access increased protection however this would be balanced against potentially higher fees and access to a more limited range of products. The Council has opted up to professional client status with its providers of financial services, including advisors, banks, brokers and fund managers. Given the size and range of the Council's treasury management activities, the Director of Finance believes this to be the appropriate status for the Council's treasury management activities.

81.0 **Financial Implications:** The draft capital financing budget of £23.6m for 2023/24 has been calculated based on the reduction in balances available for investment and the increased external borrowing required.

82.0 **Other Options Considered:** The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Council believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Table 9: Alternative Strategies

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix 1 - Arlingclose Economic & Interest Rate Forecast - November 2022

Underlying assumptions:

- UK interest rate expectations have eased following the mini-budget, with a growing expectation that UK fiscal policy will now be tightened to restore investor confidence, adding to the pressure on household finances. The peak for UK interest rates will therefore be lower, although the path for interest rates and gilt yields remain highly uncertain.
- Globally, economic growth is slowing as inflation and tighter monetary policy depress activity. Inflation, however, continues to run hot, raising expectations that policymakers, particularly in the US, will err on the side of caution, continue to increase rates and tighten economies into recession.
- The new Chancellor dismantled the mini-budget, calming bond markets and broadly removing the premium evident since the first Tory leadership election. Support for retail energy bills will be less generous, causing a lower but more prolonged peak in inflation. This will have ramifications for both growth and inflation expectations.
- The UK economy is already experiencing recessionary conditions, with business activity and household spending falling. Tighter monetary and fiscal policy, alongside high inflation will bear down on household disposable income. The short- to medium-term outlook for the UK economy is bleak, with the BoE projecting a protracted recession.
- Demand for labour remains strong, although there are some signs of easing. The decline in the active workforce has fed through into higher wage growth, which could prolong higher inflation. The development of the UK labour market will be a key influence on MPC decisions. It is difficult to see labour market strength remaining given the current economic outlook.
- Global bond yields have steadied somewhat as attention turns towards a possible turning point in US monetary policy. Stubborn US inflation and strong labour markets mean that the Federal Reserve remains hawkish, creating inflationary risks for other central banks breaking ranks.
- However, in a departure from Fed and ECB policy, in November the BoE attempted to explicitly talk down interest rate expectations, underlining the damage current market expectations will do to the UK economy, and the probable resulting inflation undershoot in the medium term. This did not stop the Governor affirming that there will be further rises in Bank Rate.

Forecast:

- The MPC remains concerned about inflation but sees the path for Bank Rate to be below that priced into markets.
- Following the exceptional 75bp rise in November, Arlingclose believes the MPC will slow the rate of increase at the next few meetings. Arlingclose now expects Bank Rate to peak at 4.25%, with a further 50bp rise in December and smaller rises in 2023.
- The UK economy likely entered into recession in Q3, which will continue for some time. Once inflation has fallen from the peak, the MPC will cut Bank Rate.
- Arlingclose expects gilt yields to remain broadly steady despite the MPC's attempt to push down on interest rate expectations. Without a weakening in the inflation outlook, investors will price in higher inflation expectations given signs of a softer monetary policy stance.
- Gilt yields face pressures to both sides from hawkish US/EZ central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales will maintain yields at a higher level than would otherwise be the case.

DRAFT – Highlighted entries relating to Q3 balances will be confirmed in updated version in Q4

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25
Arlingclose Central Case	3.00	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.50	3.50	3.50
Downside risk	0.00	0.25	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3-month money market rate													
Upside risk	0.00	0.25	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25
Arlingclose Central Case	3.00	3.90	4.40	4.40	4.40	4.35	4.30	4.25	4.00	3.75	3.75	3.75	3.75
Downside risk	0.00	0.25	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
5yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.36	3.65	3.90	3.90	3.90	3.90	3.80	3.70	3.60	3.50	3.40	3.30	3.20
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.46	3.70	3.75	3.75	3.75	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
20yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.88	4.00	4.00	4.00	4.00	4.00	3.90	3.90	3.90	3.90	3.90	3.90	3.90
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
50yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.24	3.40	3.40	3.40	3.40	3.40	3.30	3.30	3.30	3.30	3.30	3.30	3.30
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

PWLB Standard Rate (Maturity Loans) = Gilt yield + 1.00%
PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
UKIB Rate (Maturity Loans) = Gilt yield + 0.60%

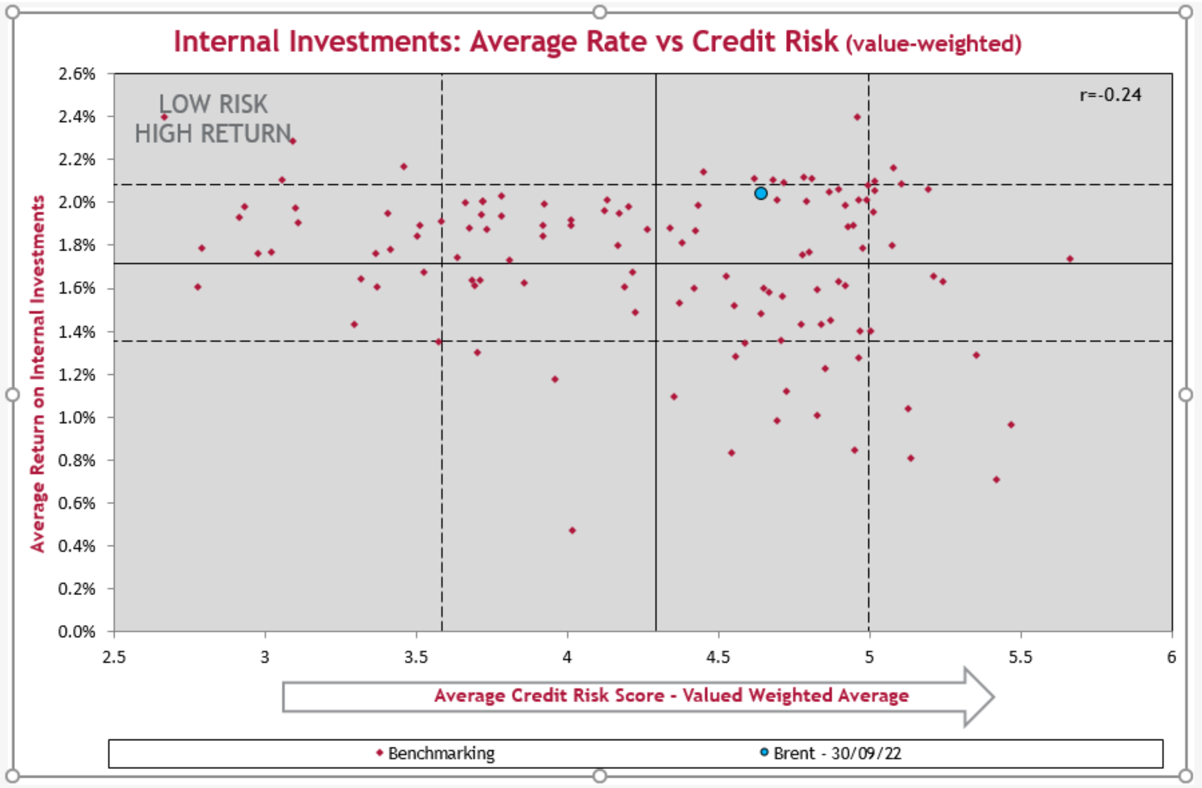
DRAFT – Highlighted entries relating to Q3 balances will be confirmed in updated version in Q4

Appendix 2 - Existing Investment & Debt Portfolio Position

	31/12/22 Actual Portfolio £m	31/12/22 Average Rate %
External borrowing:		
Public Works Loan Board	X.X	X.X
Local authorities	X.X	X.X
LOBO loans from banks	X.X	X.X
Other loans	X.X	X.X
Short Term Loans		
Total external borrowing	X.X	X.X
Other long-term liabilities:		
Private Finance Initiative	X.X	
Finance Leases	X.X	
Total other long-term liabilities	X.X	
Total gross external debt	X.X	
Treasury investments:		
Banks & building societies (unsecured)	X.X	X.X
Government (incl. local authorities)	X.X	X.X
Money Market Funds	X.X	X.X
Total treasury investments	X.X	X.X
Net debt	X.X	

DRAFT – Highlighted entries relating to Q3 balances will be confirmed in updated version in Q4

Appendix 3 - Internal Investments: Average Rate vs Credit Risk



A credit rating of 4 is equivalent to credit score of AA-. The Council has a target rating of A which is a rating of 6. The current portfolio has a credit rating of A+ (Credit score 5) which exceeds our target rating.